Liberal or conservative? CEOs' political leanings skew firms' logic in structuring initial pay packages, study shows

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When firms design the initial pay package for a new CEO, they focus on that person's tolerance or aversion to risk-taking. Research and corporate governance practices generally recommend compensating a risk-averse CEO with more performance-based pay to incentivize risk taking.

Prior research has shown that political affiliation is an indicator of a CEO's willingness to take risk—liberal CEOs are bigger risk-takers than their conservative counterparts. New research from the University of Notre Dame set out to examine whether conservative CEOs receive more performance-based pay to incentivize them to take more risks for the firm, but instead, they found the opposite is true.

Newly appointed, conservative CEOs who are naturally more risk averse receive less performance-based pay than those who are more willing to take risks, and more liberal CEOs get more performance-based pay, according to "The influence of CEO risk tolerance on initial pay packages," forthcoming in *Strategic Management Journal* from Timothy Hubbard, assistant professor of management in Notre Dame's Mendoza College of Business, along with Scott Graffin and Eric Lee from the University of Georgia and Dane Christensen from the University of Oregon.

It happens, Hubbard explains, through a process of matching (CEOs join firms that compensate the way they prefer) and tailoring (boards tailor pay to the individual CEO).

"Our study shows new CEO compensation mirrors their existing risk preferences," he says. "CEOs are attracted to firms that offered the prior CEO a pay package that is similar to what they would naturally want to have—or appeals to their risk tolerance. And there's a little bit of tailoring happening where the new CEO is receiving a different pay package based on their personal risk preferences as measured through their political orientation."

In an effort to understand how CEOs might change a firm after their appointment, the team challenged the traditional wisdom that if you want change within a firm, the board should load up the CEO with incentive-based pay. Instead, they incorporated into their research the differences

between individual CEOs.

"This is really important," Hubbard says, "because when we look at how CEOs change the strategy of their firms, we find that conservative CEOs don't react to performance-based pay, whereas with liberal CEOs, as you increase the performance-based pay, they end up changing the firm a lot more. This leaves open the question for boards and shareholders: How do you encourage more conservative-leaning CEOs to enact strategic change? This study shows that increasing performance-based pay does not result in conservatives enacting strategic change."

The team looked at 739 CEOs at 485 companies in the S&P 500 between 1995 and 2011 and measured CEOs' political orientation based on their political giving. Their performance-based pay was determined by how much of their salary was conditional on firm performance—stock options, bonuses—compared to their salaries. To investigate the effect of political orientation and initial pay on change, they looked at changes in resource allocation patterns at firms, their level of merger activity and changes in research and development.

More information: Scott D. Graffin et al, The Influence of CEO Risk Tolerance on Initial Pay Packages, *Strategic Management Journal* (2019). DOI: 10.1002/smj.3112

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